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Hans van Ees*

Stakeholder Democracy as a Katalyst to Corporate Value Creation?**

Abstract – The effectiveness of institutions of internal corporate governance, in particular the board of directors, is addressed from three theoretical perspectives. Corporate governance designs range from authoritarian, a single authority or controlling stakeholder, to democratic, shared authority and more controlling stakeholders. The distinction between the distribution of value created and value creation is introduced in the analysis as a relevant moderating variable. In case the emphasis is on the distribution of value created both the extended principal-agent perspective and the mediating hierarchy perspective on the corporation argue that stakeholders should not be represented in the board. Second, by building upon the mediating hierarchy perspective, in situations of multiple enfranchised stakeholders, it is most effective that all stakeholders transfer their control rights to the board, to enable relationship-specific investments. In case the analysis shifts to value creation, a strategic contingency perspective on corporate governance introduces the commitment and loyalty of stakeholders to the firm and their firm-specific and industry-specific experience and expertise as key soft-governance variables in the analysis of effective board behaviour. To the extent that these capabilities are distributed over multiple stakeholders, the effectiveness of governance is increased by having these stakeholders represented in the board.

Stakeholder-Demokratie als Katalysator für die Schaffung von Unternehmenswert?

Zusammenfassung – Die Effektivität von Corporate Governance-Institutionen, insbesondere des Vorstands, wird aus drei theoretischen Perspektiven betrachtet. Corporate Governance-Designs reichen von autoritären Formen mit ungeteilter Autorität bzw. einem einzigen kontrollierenden Stakeholder bis hin zu demokratischen Formen mit geteilter Autorität und mehreren leitenden Stakeholdern. Die Unterscheidung zwischen der Verteilung des geschaffenen Werts und der Schaffung von Wert wird als wichtige moderierende Variable in die Analyse einbezogen. Wird die Verteilung des Werts betont, sollten Stakeholder sowohl nach Ansicht der erweiterten Principal Agent- als auch der Mediating Hierarchy-Perspektive nicht im Vorstand vertreten sein. Gemäß der Mediating Hierarchy-Perspektive ist es in Situationen mit Stimmrechtsübertragung außerdem am effektivsten, wenn alle Stakeholder ihre Kontrollrechte an den Vorstand abgeben, um beziehungsspezifische Investitionen zu ermöglichen. Konzentriert sich die Analyse auf die Schaffung von Wert, werden aus einer Strategic Contingency-Perspektive die Bindung und Loyalität von Stakeholdern zu ihrer Firma sowie ihre firmen- und branchenspezifische Erfahrung und Expertise als Schlüsselvariablen der Soft Governance berücksichtigt. Sofern diese Fähigkeiten über mehrere Stakeholder verteilt sind, wird die Effektivität der Governance verbessert, wenn diese Stakeholder im Vorstand vertreten sind.

Key words: **Effective Corporate Governance, Board of Directors, Multiple Enfranchised Stakeholders**

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1. Introduction¹

Corporate governance structures the rights and responsibilities of stakeholders (Aoki 2001) and the nature of the relationships between the firm, i.e. top management, and its stakeholders. By shaping the bargaining positions over the rents of firm and allocating risks over different stakeholder groups, institutions of corporate governance affect the incentives to contribute resources to the firm. From this perspective, institutions of corporate governance, such as the board of directors, affect the commitment of stakeholders to corporate activities.

Building upon that argument, the research objective of this paper is to analyse to what extent the existence of multiple enfranchised stakeholders, besides shareholders, also implies a more democratic nature of effective corporate governance. In particular, we will analyse to what extent multiple enfranchised stakeholders do imply that more democratic corporate governance structures, such as the German regime of codetermination, are more effective to sustain the competitive advantage of the firm.

Our analysis starts in section two with a short digression on the changing nature of business and the modern firm in order to illustrate the relevance of research objective. Subsequently, the paper takes up the research question from three alternative theoretical perspectives. In section three, the research question is addressed from the extended principal-agent perspective, the dominant model in the corporate governance literature. It is concluded that this model offers a straightforward (negative) answer to the research question but that the underlying arguments are subject to criticism. In order to seek to overcome these theoretical deficiencies, section four introduces the mediating hierarchy perspective on the corporation as introduced by Blair and Stout in an article on a team production theory of corporate law (1999). The mediating hierarchy perspective develops the proposition that particularly, by transferring control to an independent board, stakeholders enable relationship-specific investments that may favorably affect the competitive advantage of the firm. Similarly, it can be argued that in situations of multiple enfranchised stakeholders it is more efficient to centralize decision-making power beyond the discretionary powers of stakeholders.

In section five, it is concluded that both theoretical approaches have in common the emphasis on the distribution of value created, on the one hand, and the general applicability of the recommended design of effective corporate governance, on the other. In section six of the paper, an organizational-theoretic perspective is introduced into the analysis, which puts a larger emphasis on strategy and value creation, as such and extends the previous literature by introducing several governance-related industry and technology contingencies that may to qualify the overall validity of the answers

¹ This paper grew out of discussions on substantially different paper on this topic presented at the Academy of Management Meeting in Seattle, August 2003 and the conference on *Corporate Governance and Firm Organization: Nexuses and Frontiers* at Bocconi University, Milan, 5-6 December 2002. The comments and suggestions of the participants of these conferences are gratefully acknowledged as well as, the contributions to earlier drafts of Theo Postma and SOM Research master student Qin Lin in developing some of the ideas of this paper.

offered by the aforementioned approaches. Finally, section seven offers some conclusions and discusses the opportunities for subsequent research.

2. The changing nature of business

When discussing corporate governance, the stylized conception of a corporation is a large asset-intensive firm, with clear-cut organisational boundaries and control concentrated at the top. The firm's competitive advantage arises from economies of scale and scope and the business environment of the text-book corporation is characterized by limited competition in in- and output markets, disfavours the power of the stakeholders. Employees have limited outside opportunities, which enables the corporation to exert considerable corporate power over specialised human capital. The unique capabilities of the corporation reside primarily in physical capital assets and the efficient scale of the firm requires massive external funding, and hence, dispersed ownership. The latter creates a concentration of power at the top of the firm as the control rights of the dispersed shareholders are transferred to knowledgeable top managers. Shareholders are considered to be the only residual claimants, implying that maximising shareholder value is identical to maximising firm value. In this context, the problem of effective corporate governance is predominantly a problem of structuring and protecting shareholder rights (principal-agent problem).

The business environment of the 21st century fundamentally differs from the environment of the text-book corporation (Barkema et al. 2002). In the first place, the nature of competition has changed. Deregulation and globalization have increased the liquidity of most markets. The increased liquidity and the growth of modern financial markets have created more exit options for financial stakeholders and increased their bargaining power relative to other stakeholders. More intense competition in output markets has increased customer power and the need for continuous differentiation and innovation to sustain competitive advantage. The importance of economies of scale as a source of competitive advantage has diminished and the shrinking lead time of innovations and the importance of time to market have increased the importance of non-technical innovations, intangible assets and human capital (Baruch Lev 2001). In the second place, the surge of ICT-technology has changed the nature of organisation. Communication and co-ordination costs have fallen dramatically, which offers opportunities to (groups of) relatively small firms to challenge the efficiency standards of large conglomerates. Large conglomerates have been broken up and looser forms of cooperation between independent firms have become more important. In this context, the ability to integrate with other business partners is becoming more and more a core competence. In the third place, the nature of work has changed. Along with the intensified competition and technological advancements, service industries and the service components in other industries have developed into the most important drivers of value creation (Quinn/Baruch/Zein 1997). Also this development has increased the importance of non-technical innovations, intangible assets and human capital.

As far as the consequences of these developments for the enterprise are concerned, it can be observed that in the first place, most of the aforementioned strategic changes imply a shift of decision-making power from the top to the lower

levels of the organisation or outside the organisation (Rajan/Zingales 2000). In the second place, it is relevant to observe that the property rights on human capital reside with individuals and cannot easily be transferred to the corporation. In the third place, the residual risks of corporate activities are more often shared by different stakeholder groups, including employees. Therefore, it can be argued that the changing nature of business implies that the corporation of the 21st century is characterised by more enfranchised stakeholders, besides shareholders.

3. The extended principal-agent perspective

In the context of an extended principal-agent perspective on effective corporate governance, the firm is considered as a unique bundle of complementary relationship-specific assets under common ownership. Stakeholder investments, i.e. transactions between the firm and the stakeholders that concern the transfer of the ownership rights on the assets to corporation, are governed by contracts. Emphasizing the legal entity of the corporation, the firm can be denoted as a nexus of contracts, (Williamson, 1985). The transfer of ownership concentrates decision-making power at the top of the organization in the hands of top management, the knowledgeable professionals contracted to manage and control corporate activities so as to maximize the firm value. The bilateral principal-agent problem arises to the extent that the interests of the managers conflict with the interests of the stakeholders in situation where the associated principal-agent contracts are incomplete (Zingales 1997, 2000; Rajan/Zingales 2000). In the organizational context, the principal-agent problem is one of the manifestations of the complex multilateral bargain about the distribution of value created (rents) by the organization. In a more general perspective, this bargain is shaped by the allocation of decision rights in situations not foreseen in contracts, given the ex ante allocation of property rights, the exit options of the stakeholders and the wider governance context, i.e. the judicial system, the transparency of markets, professional norms, etc. When contracts are complete all possible conflicts of interest can be taken into account at the time the investment decisions is taken. However, contracts are not fully contingent. As a result, problems of moral hazard and hold up emerge. Corporate governance institutions allocate residual control rights, which give agents (managers, shareholders, employees) decision-making power in situations not foreseen in contracts (Grossman/Hart 1986; Hart 1995; Boot/Macey 1999).

Through its impact on the distribution of the value, the corporate governance structure may also affect the creation of value (Rajan/Zingales 2000: 7). In the first place, the ex post bargaining position of stakeholders affects the ex ante incentive to invest in relationship-specific assets. In the second place, institutions of corporate governance affect co-ordination and negotiation costs. For instance, costs may rise as a result of activities directed towards getting a larger share of the surplus instead of creating the surplus. In the third place, the ex post bargaining position may affect the distribution of risk among stakeholders (e.g. shareholders vs. employees).

Effective corporate governance structures allocate this risk to stakeholders with the smallest risk-aversion (Jensen/Meckling 1976), minimize costs and create the highest incentives to engage in value-creating activities so as to achieve the highest

commitment of stakeholders to the corporation. Similarly, in a business context where the risks of value creation are shared among stakeholders (more enfranchised stakeholders), the surpluses will be shared more evenly among these groups, for instance, through performance contracts. On the other hand, if stakeholders share control rights (multiple principals) as in codetermination, there is the risk of no decision. To cut through this dilemma, the stakeholder with the highest residual risks to loose (residual) income, is given the residual control rights, as this is the stakeholder with the highest monetary incentive to effectively monitor the others. To increase effective monitoring, this activity is best delegated to a body of professional agents, the board of directors. By implication of the principal-agent solution, all other stakeholders will invest sub-optimally, but this is the inevitable characteristic of constrained second-best. As the focus of the principal-agent perspective is on control and the distribution of value created, the constrained-best corporate governance structure achieves stakeholder co-operation through enhancing monitoring ability. In this context, the virtues of corporate governance objectives, such as accountability, transparency, and integrity are primarily relevant as they may improve monitoring abilities of the stakeholder that bears the (highest) residual risk.

To conclude, the extended principal-agent perspective with its exclusive emphasis on control does not support the proposition that a more democratic governance structure will be more effective in situations in which the residual risks to income losses are more evenly shared among the different stakeholders of the firm. That being said, it can also be argued that the principal-agent perspective does only provide support for the shareholder-primacy model to the extent that shareholders are the (only) residual claimants. Moreover, in a business where the unique firm-specific resources are distributed more evenly among the stakeholders, the monitoring stakeholder still has to develop capabilities to be able to associate effectively with the other stakeholders. The virtues of corporate governance are helpful in this respect, but the current developments in business give no ground for the idea that formal authority should be shared among stakeholders at the top of the organization.

The extended principal-agent perspective is subject to the following criticism. In the first place, the theory assumes that it is clear from the outset, who the principal and who the agent are. Formally, only the principal makes specific investments. As has been argued in the introduction, particularly the changing nature of business has increased the likelihood that both parties contribute specific inputs to the firm. In the second place, to assume that common ownership is the natural back-up for common control creates a sharp distinction between "the owners" of the corporation and other stakeholders, whose services are assumed to be hired on explicit, fully contingent contracts. In the third place, taking the view that the firm is a bundle of assets, commonly owned by the shareholders, neglects the existence of firm-specific human capital that resides with the employees. And finally, in the fourth place, by emphasizing control and value protection, the extended principal-agent perspective overemphasizes the relevance of vertical (hierarchical) relationships for value-creating activities and neglects the impact of lateral interaction on productive activities.

4. The mediating hierarchy perspective on the corporation

Alchian and Demsetz (1972) were among the first economists to explore the problematic nature of team production, i.e. the production of nonseparable output with the use of several resources, provided by different individuals. According to Blair and Stout (1999), the fundamental problem of a public corporation is not the (extended) principal-agent problem but the team production problem. "The essence of organization is to be found in the fact that productive activities require the combined relationship-specific investment and coordinated effort of two or more individuals or groups" (Blair/Stout 1999: 249). In case the joint output of the firm ("the team") is nonseparable, it will be problematic to determine how the rents of the firm are divided. As in the extended principal-agent perspective, the assumption of rational self-interested individual behaviour implies that *ex ante* distribution rules invite free-riding in a team and *ex post* rules opportunistic behaviour and rent seeking. Indeed in case the team output is (e.g. equally) divided among team members it is always rational to free ride on the team, as team members enjoy all the benefits of shirking, but will only bear a fraction of the costs. To cut through this dilemma and to let each team member bear the full costs of his shirking, all team members will have to suffer in case any one of them shirks. However, that solution is theoretically not feasible as the budget constraint is broken. If the team generates a surplus but not enough to "prove" that no one shirked, where does the undistributed surplus go? Holmstrom (1982), in a principal-agent model, has formally derived that the arrangement of an outsider, who absorbs the team surplus, should the team not meet the target, i.e. in the event of shirking, generates the appropriate group incentive to co-operate and not to shirk as well as satisfies the budget constraint. Fundamentally important in this respect is that the outsider cannot manipulate the efforts of the individual team members. The introduction of the outsider has been interpreted, also by Holmstrom, as providing a rationale for the separation of ownership and labour in corporations with the shareholders being the owners. However, Blair and Stout *reject* that interpretation on the argument that the shareholders are in fact part of the team and cannot be considered as outsiders. Instead, they argue it is the legal entity of the corporation itself that serves as the outsider as it is the (public) corporation itself "that holds title to the firm's assets and serves as the repository for all its residual returns until they are paid out to shareholders and other stakeholders" (Blair/Stout 1999: 269). It is the particularly the collaboration between all team members (the stakeholders) that generates the value and hence it is in the collective interest of all stakeholders to minimize shirking and rent-seeking. Particularly when teams grow larger, the institutionalization of outsider-control without the ability of the outsider to affect team performance is required to assure cooperation. This institutionalization can be denoted as the incorporation of the team, which is the arrangement by which all the property rights on the assets are transferred to a new legal entity, the corporation. The control of the corporation is given to a board of directors, a body of disinterested outsiders, who has ultimate decision-making authority how to use the assets, to hire and fire future company directors and to resolve any internal dispute between the members (stakeholders) of the organization (the mediating hierarchy). In the mediating hierarchy perspective on the firm, the

board of directors at the top of the hierarchy mediates in internal disputes and solves stakeholder conflicts so as to enable specialized investments.

In return for the transfer of their ownership rights, stakeholders receive claims on the rents of the organization. The nature of these claims can be different across stakeholders, e.g. in terms of the distinction between residual and non-residual claims. However, more important than this is that none of the stakeholders owns the (public) corporation, it is an entity separate of its participants. The corporation itself owns the assets contributed by the stakeholders for use in production, as well as, any produced output. This ownership structure is considered as an effective solution to the hold-up problem as all the members of the team (i.e. the stakeholders) voluntarily give up in advance the opportunity to hold up the enterprise.

As far as control at the top of the organization is concerned, the mediating hierarchy perspective implies that the board of directors is accountable to the corporation only. Directors are supposed to operate in the best interest of the firm by protecting the relationship-specific investments of *all* stakeholders, and, not necessarily only the rights of the shareholders. Team production suggests that corporate performance should be measured along a manifold of dimensions (return on assets, liabilities, wages, creditor accounts, customer satisfaction, growth of the firm etc.). Corporate governance arrangements are primarily designed to facilitate the cooperation and coordination within the team, or alternatively, among stakeholders. This includes guaranteeing the claims of the stakeholders, preventing hold-up among stakeholders, mediating between stakeholders and undertaking (strategic) activities that benefit the corporation. In this respect, the position of residual claimants is particularly important. The mediating hierarchy of a corporation can be seen as an efficient substitute for explicit contracting in situations where more than one stakeholder contributes to the firm by investing relationship-specific assets. Directors do not formally represent particular stakeholder groups; otherwise stakeholders would be able to exploit their power over the board to attempt a hold up (Blair/Stout 1999: 254). Similarly, strategic decisions should not be subjected in great detail to the approval of stakeholders. Instead, directors are supposed to re-enforce trust, corporate commitment and co-operation among stakeholders. The virtues of corporate governance, transparency, integrity and accountability, serve to achieve these objectives.

In order to be able to fulfill their duties to the organization, board members have full discretion. This obviously implies that the mediating hierarchy model offers large potential for board members to serve their own interests. Against that proposition, it can first of all be argued that stakeholders will trade off the risks on agency costs against the costs of shirking and rent-seeking in the production of output. After all, the world is considered second-best. Therefore, also the team production model cannot offer the first-best solution. In the second place, as an institution of corporate governance, the ruling of the board will be constrained by the wider institutional environment (e.g. the law or national codes of corporate governance). Particularly, corporate law can be restrictive (e.g. The Sarbanes – Oxley act in the United States) and the transparency and accountability requirements in national codes of corporate governance can create a considerable damage to reputation in the case of the abuse of power by board members. In the third place, boards can effectively

structure their efforts so as to maintain their reputation of impartiality and loyalty to the firm. Their status of disinterested trustees, distinct from employees, can, for instance, be reinforced by flat compensation schemes and the absence of stock ownership and careful board member selection procedures, focusing on competence and integrity rather than on stakeholder representation. Finally, powerful social and cultural norms related to trustworthiness may prevent the systemic abuse of the position of a member of the board.

Concerning the (s)election of the board of directors and the issue of the shareholder voting rights in this respect, Blair and Stout (1999: 309) argue that these voting rights are largely instrumental and in no way pinpoint to a subordination of the board to the shareholders. By contrast, the issue of shareholder voting rights is defended by the argument that shareholders are in the best position to withstand the board in the interest of all the stakeholders (the corporate coalition). This is because the interests of shareholders are relatively homogeneous and their bargaining position is generally stronger in view of the liquidity of capital markets. By no means, the prevailing existence of the limited voting rights of shareholders does imply that shareholders are supposed to control the board. At best, the limited voting rights can be seen as a compensating for a relatively vulnerable position within the firm, as shareholders are not as involved in the firm's day-to-day operations, as many other stakeholders are. On the other hand, it has also to be acknowledged that limited liability and easy exit options do reduce the vulnerability of the shareholders. Nevertheless, granting additional voting rights to other stakeholder groups, such as employees, would probably only increase the costs of voting without adding to the efficiency and effectiveness of the (s)election and other decision-making procedures.

To conclude, the team-production theory with its emphasis on team production, co-operation and coordination does not support the proposition that a more democratic governance structure will be more effective in situations where the residual risks to value-creation are more evenly shared among the different stakeholders of the firm. To the contrary, the team-production model argues that although the stakeholders (including the employees) may select the board and board members may even represent different stakeholder groups, once installed the board enjoys ultimate decisionmaking authority. It is important to emphasize that this position does not necessarily argue against the alleged efficiency of giving other stakeholders besides shareholders the right to select board members (see also Gorton and Schmid 2004). The crucial emphasis is on the formal authority distribution after the board has been selected. In a mediating hierarchy perspective the board itself is the highest decision-making authority, which implies that stakeholders transfer their control rights to the board in order to facilitate relationship-specific investments from all stakeholders. Obviously, the board of directors has to develop capabilities to be able to associate effectively with all the stakeholders and to assure credibility of the board. The virtues of corporate governance, integrity, transparency and accountability are essential in this respect so as to maintain the relationships with the stakeholders and to legitimize the decision-making power of the board. There's no theoretical foundation for the idea that formal control rights should be shared among stakeholders at the top of the organization, nor that stakeholders should be represented in the board. Board

members are better seen as trustees rather than as agents, who mediate in disputes and solve conflicts so as to facilitate specialized investments. The effectiveness of internal corporate governance is best guaranteed by an independent board of directors (Hermalin/Weisbach 2001), although the notion of independence is subject to debate in this respect (McNulty/Roberts/Stiles 2005).

When dealing with the prevailing dominance of the shareholder-primacy model in the current business world, it is interesting to observe the alternative explanations offered by the extended principal-agent perspective, on the one hand, and, the mediating hierarchy perspective, on the other. The former would explain shareholder primacy as being the result of an efficiency principle. Shareholders hold the majority of the residual risks and hence, are most committed to closely monitor corporate activities. Ownership in this respect is considered to be the most powerful back-up of residual control rights. Interestingly, for closely held corporations and private firms, the proponents of the mediating hierarchy perspective on the firm do accept that explanation, but not for public corporations. In that context, shareholder primacy is better explained from a political perspective. In their view, the correct argument would be that the changes in the nature of business and markets have shifted the balance of power toward financial stakeholders. There's no theoretical argument why this should promote effective corporate governance, let alone the creation of value. To the contrary, the pervasive impact of shareholders on corporate decision-making is more likely to increase the probability of hold-up by the shareholders and sub-optimal (non-committed) investment behaviour by other stakeholders. The sometimes observed emphasis on short-term profits at the expense of investments in innovative activities can perhaps be regarded as an illustration of opportunistic behaviour by the shareholder groups.

5. An assessment of the extended principal-agent and the mediating-hierarchy perspectives

As the extended principal-agent perspective, the validity of mediating hierarchy perspective on the firm is subject to qualifications and criticism. In the first place, also Blair and Stout (1999: 281) argue that their perspective does particularly apply to large publicly held firms. When ownership is concentrated in the hands of a few shareholders, who also have the statutory right to select and appoint the board, the extended principal-agent perspective probably better describes the actual governance situation. In the second place, it is important to emphasize that their statutory position at the top of organization does not imply that the board is incorporating the management function (Fama/Jensen 1983). The status of the board is more captured by the fact that the board is able to take the ultimate decisions rather than that the board actually takes them.

More fundamentally, it can be observed in the third place that both theoretical approaches particularly address the formal and structural characteristics of corporate governance (van Ees et al. 2005). A growing number of organizational-theoretic studies have emphasized the need to study more closely the behavioural practices, processes and relationships within the firm and between the firm and its environment. In this perspective, firms are conceptualized as complex sets of human relationships and

resources, where the development of routines plays a major role in keeping the internal coherence (Zahra/Filatotchev 2004). Moreover, the cognitive ability of organizational actors to effectively collect and process information is generally considered to be limited (Rindova 1999; Zahra/Filatotchev 2004), which may lead to the need to create and coordinate dispersed knowledge through various planning and control systems. Hence, from this organizational-theoretic perspective, in the first place effective institutions of corporate governance create value, not primarily by solving conflicts of interests and disputes, but more by facilitating (new) knowledge and value creation, offering advice and coordinating of stakeholder expectations and activities. Indeed, from an organizational-theoretic perspective, the relationship between corporate performance and corporate governance, which underlies the notion of effective corporate governance is subject to qualifications. In general, the creation of corporate value results from the dynamic interaction of resource deployment and resource development through organizational learning. Existing business opportunities are more intensively explored, new opportunities for business are developed and new organizational assets are created. The emphasis on cumulative and collective creation and organizational development, creates a problem for both the extended principal-agent perspective as well as the mediating hierarchy perspective on corporate governance, as both theories are built upon the assumption of a given predetermined set of investment opportunities and well-defined property rights. To put it differently, the assumption that the actors are fundamentally unaware of possible contingencies and do not understand the business environment they operate in is crucial. Indeed, also with multiple enfranchised stakeholders, corporate governance in these approaches concerns the distribution of the returns associated with a given set of investment opportunities among the stakeholders with a stake in the selected investment projects. Apparently, this approach does not allow for the possibility that the returns on stakeholder investments are generated from the discovery of new opportunities and resources, where the property rights to the new assets reside with the organization itself rather than that they are attributable to particular stakeholder groups.

In the second place, the emphasis on value and resource creation and strategy in organizational-theoretic perspective implies that the general validity of the conclusions offered by both the extended principal-agent perspective and the mediating hierarchy perspective on the corporation may be criticised. The basic argument underlying contingency thinking in organization theory is that uniform an optimal organisational design does not exist. On other hand, not all designs are equally good, implying that particular combinations (fits) of organizational, functional and contextual characteristics provide better results than others. In the next section, we apply an organisational-theoretic analysis of corporate governance to situations with multiple enfranchised stakeholders and elaborate upon the industry and technology-based contingencies that may affect the effectiveness of the institutions of corporate governance, in particular the board of directors.

6. An organizational-theoretic analysis of the corporate performance-corporate governance nexus

In addressing the implications of the design of effective institutions of corporate governance, Lazonick and O'Sullivan (2000) argue that the dynamic and cumulative nature of value creation processes implies a much larger scope for institutions of corporate governance. Value creation processes in firms can be characterized as developmental (1), implying the commitment of resources to irreversible investments for a prolonged period; organizational (2), i.e. resources are allocated to facilitate organizational learning and the integration of human competencies and physical resources and strategic (3), implying that resources are allocated to activities that are expected to create sustainable competitive advantage. As a result, when dealing with effective corporate governance, not only the distribution of the returns should be taken into account, but also the nature of the investment itself and the involvement and commitment of the stakeholders in the investment processes (Lazonick 1998; Lazonick/O'Sullivan 2000; O'Sullivan 2000). In this respect, the degree of commitment will be conditional upon the nature of the relationships between the stakeholders and the firm. Lazonick and O'Sullivan (2000) particularly focus on the determinants of financial commitment, but the notion of commitment can be extended to other stakeholders, e.g. workers, top management, as well. For instance, similar to blockholding, high firm-specific investments in human capital are generally associated with a high commitment and loyalty of employees. In addition, the organisation of corporate governance will affect the organizational integration, as the organizational setting creates incentives for the integration of resources and competences and cumulative learning.

This strategic dimension of the relationship between the stakeholders and the firm is focused upon value creation. It is concerned with the provision of essential services and resources in strategic decision-making, such as expert advice, legitimacy and counsel, as well as links to important external resources and other organisations. In contrast, the control dimension is directed towards the distribution of value created and safeguarding the interests of the residual claimants. Whereas, the extended principal-agent perspective and the mediating hierarchy perspective primarily focus upon effective value distribution, the organizational-theoretic approach is more concerned with value creation, as such. Particularly, the balance between the value-creation and value distribution, as incorporated in alternative corporate governance institutions, will favourably influence corporate performance and the underlying allocation of resources to cumulative learning processes.

The strategic perspective on the effectiveness of corporate governance also implies that the relationship between the institutions of corporate governance and performance may vary across contexts and technology. Indeed, the creation of value in different industries can be characterised along different dimensions. In the first place, by type, i.e. by the emphasizing the creation of (new) products, processes and organisational development. In the second place, by nature, incremental or radical change or development and in the third place, by the distribution of expenditures over tangible and intangible assets. Moreover, this variation may change over time.

In line with the variation in industry and technology characteristics, the following governance-related industry constructs can be defined (Tylecotte 1999; van Ees/Postma 2002). The first construct is denoted, visibility, which can be defined as the extent in which stakeholders not closely involved in the value-creating process are able to judge what resources are being devoted to it and how efficiently they are used. The more complex the transformation process, the lower visibility and the more difficult control. The low degree of visibility increases residual risks and may affect funding and other relationship-specific investments. Generally, in the context of low visibility, stakeholders need firm-specific expertise to contribute effectively to processes of strategy and control. In the second place, novelty, the extent in which value-creation processes are built upon the development of radically new technologies. Novelty relates to the technology nature of value-creating processes and affects monitoring capabilities, resource characteristics and risk attitudes. The higher novelty, the greater the industry-specific knowledge needed for effective governance. In the third place, appropriability refers to the non-rivalry and non-excludability characteristics of value creation processes. Low appropriability reflects diffuse patterns of residual decision rights. Sometimes, decision rights are concentrated in the hands of stakeholders with decisive information (patent rights, complementary tangible assets), which increases appropriability. For instance, patenting regulates the protection of corporate intellectual property rights and offers the owners of the patent a well-defined claim to the rents of the patent-protected activities. On the other hand, partnerships are usually associated with more dispersed decisive information. In such a context, the corporation may not be able to capture all the rents from value-creating activities or, is the appropriation of the rents more diffuse.

Applied to institutions of corporate governance and in particular to the board of directors, a contingency approach to the effectiveness of alternative configurations of corporate governance in terms of value creation will be related to the aforementioned three industry and technology characteristics (see Table 1).

Table 1: Effective corporate governance at the firm level

		High levels of stakeholder commitment and loyalty are achieved by	High levels of organizational integration are achieved by
Visibility	High	Formal market-based stakeholder relationships	Emphasis on control, outsider-dominated boards
	Low	Informal network-based stakeholder relationships	Emphasis on strategy (quasi-insider) dominated boards
Novelty	High	Formal market-based stakeholder relationships	Emphasis on control, outsider-dominated boards
	Low	Informal network-based stakeholder relationships	Emphasis on strategy (quasi-insider) dominated boards
Appropriability	High	Formal market-based stakeholder relationships	Emphasis on control, outsider-dominated boards
	Low	Informal network-based stakeholder relationships	Emphasis on strategy (quasi-insider) dominated boards

The corporate governance institutions in Table 1 are characterized at the level of the firm. The focus is on the composition and expertise of the board of directors and the

diffusion of decision rights among stakeholders, including top managers and (other) employees. In this respect, a large diffusion of control rights is associated with network-based relationships and a small more concentrated dispersion with market-based stakeholder relationships. The configurations in Table 1 allow the following conclusions. Particularly in contexts of low visibility, low novelty and low appropriability, the board of directors can be seen as an institution of corporate governance, relevant for establishing organizational integration and high organizational commitment and loyalty of stakeholders. On the other hand, in situations high visibility, high novelty, and high appropriability, market-based control and incentive systems may elicit the required relationship-specific investments from stakeholders. With alienable assets and high visibility in production, market control will allocate property rights to the first best use of the assets. In line with this observation, an outsider-dominated board of non-specialist directors, emphasizing the control function of the board will be most effective. To the extent that assets are thick, not standardized, connected and non-alienable as with human capital and low visibility characterizes technology, more co-operative and network-based decision-making structures may direct resources more efficient (Kogut/Sauder 1992). In line with this observation it can be argued that insider-dominated boards of directors emphasizing the strategy role of the board will be more effective.

In industries characterized by low visibility, low novelty and low appropriability, successful performance at the firm level will particularly be associated with long-term network-based (stakeholder) relationships. New organizational forms, based on more voluntary co-operation are seen as particularly efficient for the productive sourcing of thick assets or bundles of non-alienable assets. In such a context, boards may delegate decision rights after having established the objectives to be reached. Obviously, this also requires monitoring and the ultimate decision rights, however, the emphasis is more on achieving commitment, active involvement and the ability to associate. In this line of reasoning, a more passive use of centralized authority may have a place in industries where visibility, novelty and appropriability are low. To conclude, in case firm-specific assets, including human capital are fundamentally distributed and the characteristics of production and technology are not easy to access by external stakeholders, the maintenance of the relationships with and between the different stakeholders will dominate over the exercise of control over productive activities. Institutions of corporate governance and in particular, the board of directors, may contribute to value creation in this respect, by decreasing relational risk and building trust and loyalty between stakeholders.

7. Conclusion, effective corporate governance in relation to organizational democracy

In this paper, the effectiveness of institutions of internal corporate governance, and in particular the board of directors, has been addressed from three rather different theoretical perspectives, the principal-agent perspective, the mediating hierarchy perspective on the corporation and the organizational-theoretic perspective. It has been argued that the emphasis of the former two perspectives is on the formal characteristics of corporate governance in relation to primarily the distribution of

value created. Both approaches are built upon the fundamental assumption that the value of productive activities is known beforehand, although not with certainty. However, the actual added value can also deviate negatively because of incentive problems, free-rider problems and rent-seeking activities. As a result, the emphasis is on the design of effective control of behaviour that may affect the distribution of value created and indirectly create efficiency losses. By contrast, the latter approach emphasizes the value-creation perspective of productive activities, starting from the notion that the ultimate value of productive activities is not at all known beforehand and has to be “discovered” to a considerable extent in the process of combining the assets. As a result, in the organizational-theoretic approach the scope of effective corporate governance is considerably larger with more emphasis on issues of strategy and associated contingencies than on control.

As far as the relationship between effective corporate governance and corporate performance is concerned, a relatively complex picture emerges from this paper. Obviously, this has implications for the answer to the research question. First of all, it can be concluded that in case the emphasis is on value distribution, both the analysis of, respectively, the extended principal-agent perspective and the mediating hierarchy perspective on the corporation, indicate that there is no theoretical support for the proposition that a more formal representation of stakeholders in the board will benefit the effectiveness of corporate governance. Second, building upon the mediating hierarchy perspective and arguing against the limited scope of the extended principal-agent perspective, it can be claimed that in situations of multiple enfranchised stakeholders, it is most effective that all stakeholders give up control in order to elicit relationship-specific investments that may favourably affect the value of the firm. Similarly, it can be argued that in situations of multiple enfranchised stakeholders, it is more efficient to centralize decision-making power beyond the discretionary powers of the stakeholders.

In case the focal point of the analysis shifts to the creation and discovery of value, these general conclusions no longer hold. The introduction of an organizational-theoretic perspective in corporate governance and particular in the roles the board introduces the commitment and loyalty of stakeholders to the firm and firm-specific and industry-specific experience and expertise as key soft-governance variables in the analysis of effective board behaviour. To the extent that these capabilities are more evenly distributed over different stakeholders, it may increase the effectiveness of governance to have these stakeholders represented in the board.

As a result, the introduction of the distinction between value creation and value distribution seems to create a paradox. Indeed the issue is to reconcile the need for centralized decision-making from the perspective of the distribution of value created, with the need to decentralize decision-making and to share authority viewed from the perspective of value creation. In our view, the solution of the paradox is precisely where the role of the board becomes crucial and even more important than in shaping the strategy of the firm or monitoring management activities. In our view, effective boards are able to create and maintain accountability to all stakeholders although they have all authority (see also Roberts/McNulty/Stiles 2005). Indeed, the challenge is to have available all the authority to control without the need to use it. Similarly, to

engage in strategy shaping without losing the authority to control. Accountable board members are able to cut through these dilemma's primarily because they have the expertise and attitude to associate with all the stakeholders and to challenge management. Formal representation rights are probably only limiting the required formal and informal independence of the members of the board, in this respect.

Finally, in this paper, the effectiveness of internal corporate governance institutions is addressed, in particular, the board of directors. Obviously there are limitations to the approach of this paper, which may provide additional challenges for subsequent research. In the first place, this analysis of paper has addressed the issue of effective corporate governance. It has to be emphasized that the conclusions of this paper may be subject to qualification once the issue of the legitimation of institutions of corporate governance is also addressed (see also, Aguilera/Cuervo-Cazurra 2004). In the second place, there's a considerable variety of corporate governance structures and the interdependence of institutions of internal and external corporate governance is straightforward. Furthermore, the institutions of corporate governance are themselves subject to changes in the wider institutional environment (e.g. changes in legislation or national codes of corporate governance). These institutional changes may be a response to social pressures that are not related to the dynamics of the value creation process (van Ees/Postma 2005). For the sake of the argument, we, however, have chosen to neglect these aspects of institutional change in this paper and to primarily focus on the effectiveness of internal corporate governance.

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